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C O N F I D E N T I A L SECTION 01 OF 03 YEREVAN 000358

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SUBJECT: TREASURY DAS MEYER'S MEETINGS IN YEREVAN

YEREVAN 00000358 001.2 OF 003

Classified By: Ambassador Marie L. Yovanovitch. Reasons 1.4 (b/d)

SUMMARY

11. (C) Acting Treasury DAS for Europe and Eurasia Eric Meyer met May 13 with the Chairman of the Central Bank of Armenia (CBA), Armenia's Minister of Finance and the IMF Resident Representative for Armenia. All three painted a dim picture of Armenia's macroeconomic situation, though noted that due to years of high GDP growth, Armenia was better prepared than many other countries for the global economic crisis. A fall in tax revenues has forced the GOAM to defer and possibly eliminate approximately 12 percent of its 2009 expenditures. The GOAM has also received over USD 1 billion in credits from IFIs, some of which it hopes to use for budgetary support. The GOAM is seeking an additional credit of USD 250 million from the IMF, and an IMF team was in Yerevan at the time, consulting with the Prime Minister and Minister of Finance. End Summary.

GDP FALLING...

12. (C) In the first quarter of 2009, Armenia's GDP fell at an annual rate of 6.1 percent. Most of the decline has been in the real sector, including a 20 percent drop in construction during the first quarter, and a 9.5 percent fall in industrial output. While the IMF's latest estimate is for Armenia's GDP to decline by five percent overall in 2009 (in early March it predicted minus 1.5 percent), Finance Minister Tigran Davtyan predicted it will continue to worsen over the course of the year. Armenia is experiencing a serious drop in FDI (75 percent of which came from Russia last year), and remittances (30 percent in the first quarter). Armenia's mining sector has been hit severely by a 60 percent drop in metals prices from their mid-2008 peak; while copper prices have since rebounded to USD 4,500 per ton (up from a low of USD 2,700), prices for molybdenum, which are even more critical to Armenian exports, have not rebounded.

13. (C) Minister of Finance noted that fiscal projections are changing every month and continue to decline. The 6.1 percent first quarter fall in GDP will likely worsen in the coming months, and there is also concern about possible deflation. Budget revenues will depend on the performance of the real sector, which so far is much worse than last year. The biggest drop in tax revenues has come from imports (which pay 20 percent VAT and 10 percent Customs duties), which typically account for 40 percent of overall tax revenues. Consequently, the GOAM has done some budget reallocations, shifting some spending (about 12 percent) to the fourth quarter, though he did not rule out cutting that spending entirely. Armenia still has a low level of foreign debt

(about 30 percent of GDP).

...BUT BANKS STABLE

¶4. (C) CBA Chairman Arthur Javadyan said that Armenia's banks remain in sound condition, and IMF Resident Representative Nienke Oomes confirmed that stress tests run by the CBA on Armenian banks generally look positive. Banks have an average capital adequacy ratio of 27 percent, well above the usual recommendation of 12 percent. As the banks are maintaining high liquidity ratios (current liquidity ratio of 28 percent; general ratio of 100 percent), the CBA has not needed to make any liquidity injections into the banking system. While non-performing loans have more than doubled in recent months (from about 2.7 percent to approximately seven percent), that rate is still the lowest among CIS countries (Note: The ratio of non-performing loans may be understated because many loans that might have defaulted have had their payment terms modified. End Note). Banks have obtained long-term resources from the IFIs and increased capital by 35 percent. Overall, the debt in the banking system is relatively low, which has helped it to survive the crisis. The CBA is meeting with bank CEOs weekly to provide updates on the banking situation. The IMF has been advising the CBA not to "talk up" the situation.

DEFENDING FOREX INTERVENTION

¶5. (C) Javadyan said that the CBA will continue to focus on preserving financial stability. He and other GOAM officials continue to defend the CBA's intervention in support of the Dram (AMD); while doing so cost the CBA a large part of its foreign reserves, he claimed there was no outflow

YEREVAN 00000358 002.2 OF 003

of resources, so gross resources remained unchanged. He asserted that while the CBA's forex intervention encountered criticism from IFIs and others, now they all say that the CBA did the right thing. (Note: While IMF officials had earlier in the week made public comments that seemed to suggest they endorsed the CBA's forex intervention, Oomes said the IMF had always opposed and advised against it, but would not criticize the GOAM publicly. End Note).

¶6. (C) In the months before the CBA returned to a floating exchange rate, bank deposits moved significantly out of AMD and to USD (currently they are approximately 80 percent USD, after reaching deposit dollarization lows of 30 percent in 2008). According to Javadyan, on March 3 Armenian banks lost approximately USD 15 million (about 14 percent of 2008 profits) when the AMD devalued, as many of them had open AMD positions at the time. Javadyan insisted that the CBA is not continuing to support that AMD, though over five days since March 3 it had sold about USD 50 million since March 3 and purchased about USD 8 million in order to prevent large fluctuations; the AMD has stayed within 1.5 percent of its post-devaluation level (currently about AMD 370 per USD). Since the March 3 devaluation, the Armenian Stock Exchange has been very inactive, though the interbank forex market has been quite active. Oomes suggested that the CBA might be directing the banks to trade there, as it is easier for the CBA to monitor transactions (Comment: It may be a way to artificially drive down the exchange rate, since the transactions are less transparent than on an open market. Banks may also have different interests in the AMD's movement. End Comment).

LITTLE LENDING

¶7. (C) Although banks are relatively stable at present, there is relatively little new lending occurring. Due to the dollarization of bank deposits, Armenian banks have a

shortage of AMD to lend. Armenian law prohibits lending in foreign currencies except for mortgages, but borrowers are wary of taking out USD-denominated loans because of the forex risk. Hedging instruments for AMD are in short supply and would add about four percent to the cost of the loan if any bank wanted to convert its USD deposits into AMD loans. Some banks have reportedly attempted to persuade borrowers to convert their loans into USD.

REMITTANCES DOWN

¶ 8. (C) Remittances--both commercial and non-commercial--fell 30 percent in the first quarter compared to 2008, and currency outflows fell by 47 percent. As most are dollar-denominated, remittance inflows were a significant factor in the AMD depreciation of recent years. (Note: The fall in noncommercial inflows may be somewhat overstated; as fees are lower for non-commercial transfers, many commercial transfers in the past were likely categorized as non-commercial. End Note).

GOAM TURNS TO IFIS

¶ 9. (C) Oomes confirmed the GOAM's announcement earlier in the day that it is seeking a second round of IMF financing, beyond the USD 540 million that the Fund had pledged late last year (USD 240 million of which has already been disbursed to the GOAM). An IMF team was in Yerevan at the time, meeting with the Prime Minister, Minister of Finance and other GOAM officials. IMF credits would usually be used to bolster central bank reserves, but given the GOAM's serious tax revenue shortfalls (down 17 percent in the first quarter of 2009), the GOAM would like to take advantage of the IMF's recently announced openness to expand into budget support for "fiscal smoothing" of deficits. The GOAM is also negotiating budget support from the World Bank and ADB (USD 100 million and 80 million, respectively). At present the IMF is trying to determine the financing gap. The GOAM expects a substantial gap in 2010, as well.

¶ 10. (C) Meyer acknowledged that Armenia had entered the global financial crisis in better condition than did many other countries, most of which had not experienced Armenia's sustained period of economic growth (Note: From 2002 to 2007, Armenia's GDP grew at least ten percent annually before falling to 6.8 percent in 2009. End Note) and had higher debt burdens. Meyer encouraged the CBA to stick to its IMF program and remain flexible in its policy responses; the transition to a floating exchange rate is an important first

YEREVAN 00000358 003.2 OF 003

step. He told Javadyan that the GOAM's plans for countercyclical policies make sense, given Armenia's low debt levels, but noted that it is critical for the GOAM to maintain sound fiscal policies.

COMMENT

¶ 11. (C) Given that Armenia's economic woes are largely the result of such outside factors as falling oil and metals prices, and reduced export demand, the GOAM has relatively few instruments at its disposal to combat the impact of the global economic crisis -- beyond the ill-advised path of stimulus spending while increasing debt. The IMF's GDP projections may be optimistic relative to indicators we have received, but these projections are the result of consensus within the GOAM, and the IMF will note significant downside risks. (Note: Separately, the Prime Minister told the Ambassador that the IMF predictions are less about accurate forecasts and more about calming the financial waters, so in this latter sense, he "agreed with the IMF forecast." End Note) We are also not sure why the IMF appears unwilling to criticize--even at the risk of appearing to endorse--the

CBA's forex intervention, which cost the country USD 700 million in foreign reserves while only temporarily forestalling a large and widely expected devaluation. End Comment.

¶12. Treasury DAS Eric Meyer has cleared this cable.
YOVANOVITCH